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ICRA Lanka reaffirms the [SL]A- issuer rating of Construction Guarantee Fund

ICRA Lanka Limited, Subsidiary of ICRA Limited, group company of Moody's Investors Service has reaffirmed the Issuer rating of [SL]A- (pronounced S L A minus¹) with stable outlook for Construction Guarantee Fund ("CGF" / "the Fund").

The reaffirmed rating factors in the Government of Sri Lanka (GOSL) ownership and the sovereign support to the fund; coupled with the well-established acceptance and position of the fund in the Sri Lankan construction sector with two decades of experience. ICRA Lanka notes the fund's unique operational model as a service organization in Sri Lanka, its stringent underwriting standards, and its self-sustaining operational structure that requires minimal support from the GOSL. This coupled with the entity's management and governance system through a Board of Trustees, representing key public and private sector officials, has enabled the fund to operate as an autonomous body without direct interference from the GOSL.

The reaffirmed rating strengths are partly offset by high business concentration risk in the domestic construction sector, which is closely correlated with the macroeconomic conditions. Historically, the fund's bond exposure has been highly skewed towards the state funded construction contracts. Given the government's increased fiscal constraints, ICRA Lanka views this exposure on a negative note as delayed payments from the government sector is viewed as a national issue, (as this not only impacts the contractors' cash flow profiles but also further aggravates the contractors' financial stability). Therefore, the ability of the fund to collect its levy incomes on timely manner, whilst growing the fund's guarantee exposure remains a rating sensitivity.

The rating also continues to consider the fund's concentration of exposure on a single contractor, which has accounted for 25-30% of the total cumulative bond exposure as of September 2017. Moreover, ICRA Lanka takes note of the fund's increased involvement in the aforementioned contractor's ongoing projects amidst the state employer's request to take over the contract administration of these projects. Nevertheless, these projects are in advanced stages of completion and with active involvement, the fund expects to recover the outstanding guarantees issued on behalf of the said contractor. Going forward, ICRA Lanka will continue to monitor these project exposures and the ability of the fund to successfully complete the ongoing projects and reduce its relatively high dependency would be a rating sensitivity.

During CY2016, the premium collection increased due to recovery in the local construction sector amidst the introduction of new government funded mega development projects. During CY2016, the fund has recorded a premium income of LKR 67.7 Mn, as compared to LKR 37.3 Mn in the previous year. However, during 8MCY2017, the construction sector has slowed down due to Government's fiscal constraints and the fund has recorded a premium income of LKR 30.5 Mn. The expenses as a percentage to net levy collected have increased to ~120% due to relatively lower levy income collections during 8MCY2017 (however, additional levy incomes during this period has increased with the delays in the project executions). However, the prospects for the Construction Guarantee Fund are healthy with the expected recovery of the construction sector and hence the premium income is expected to increase going forward.

¹ For complete rating scale and definitions please refer to ICRA Lanka's Website www.icralanka.com or other ICRA Rating Publications

ICRA Lanka notes the fund's comfortable liquidity profile and the healthy capitalization metrics commensurate with its business profile. The investments of the fund mainly consist of government securities and risk free assets. The leverage of the capital (the cumulative guarantees issued to capital) currently stands at 1.7(x), indicating sound capital buffer for its business albeit the maximum level set at 10(x) by the board of trustees (in the absence of regulatory capital requirements). Moreover, despite the overall adverse performance of the construction sector, the fund has been able to contain its claim levels to 4.5 % (total cumulative guarantee encashment to the total cumulative guarantee exposure in September 2017). During 8M ending CY2017, Construction Guarantee Fund has fully paid the guarantee encashment, which were mainly raised in FYE Dec 2014/15, amounting to LKR 77.7 Mn. The ability of the management to recover these amounts through legal means, remains a sensitivity of the reaffirmed rating.

Entity Profile

Construction Guarantee Fund was established in the year 1998, with the view of providing facilities to the Construction community mostly the Private Sector. Since, there was no procedure to directly give state sponsorship to finance the Private Sector, the private organization named Construction Industry Guarantee Fund was liquidated and a fully state owned institute named Construction Guarantee Fund was established. The budget proposals for 1999 presented to the Parliament in 1998 proposed to establish the Trust/Fund with a state grant and allocated LKR 100 Mn, whilst Secretary to the Treasury was tasked with implementing this proposal. Treasury Secretary as the arbiter decided to establish the Fund and to manage it through a Board of Trustees. The government had only granted LKR 55 Mn in four installments to establish the Trust/Fund. Construction Guarantee Fund in addition to providing financial facilities to construction contractors who undertake projects, has launched wide ranging other services such as Contract Management & Administration and Dispute Resolution & Dispute Avoidance in the construction industry, targeting small & medium scale construction contractors. Sri Lanka is one of the few countries to have implemented this type of services and Construction Guarantee Fund provides various guarantees and indirect financial facilities required by contractors engaged in domestic construction sector without retaining any security, insurance money or property for the guarantees offered.

The Fund reported a surplus income over expenses of LKR 82.3 Mn on a total operating income of LKR 137.9 Mn in CY2016, compared with LKR 36.9 Mn reported on a total operating income of LKR 89.0 Mn in CY2015. During 8M ended CY2017, the Fund has registered a surplus of LKR 69.9 Mn on a total operating income of LKR 107.1Mn.

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